REPORT OF EXAMINATION
OF THE

FIRST AMERICAN SPECIALTY
INSURANCE COMPANY

AS OF
DECEMBER 31, 2003

Participating State
and Zone:

California

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Los Angeles, California
April 20, 2005

Honorable Alfred W. Gross
Chairman of the NAIC Financial
Condition Subcommittee
Commissioner of Insurance
Virginia Bureau of Insurance
Richmond, Virginia

Honorable John Morrison
Secretary, Zone IV-Western
Commissioner of Insurance and Securities
Montana Department of Insurance
Helena, Montana

Honorable John Garamendi
Insurance Commissioner
California Department of Insurance
Sacramento, California

Dear Chairman and Commissioners:

Pursuant to your instructions, an examination was made of the

FIRST AMERICAN SPECIALTY INSURANCE COMPANY

(hereinafter also referred to as the Company) at the primary location of its books and records, 114 East Fifth Street, Santa Ana, California 92701.

SCOPE OF EXAMINATION

The previous examination of the Company was made as of December 31, 2000. This examination covers the period from January 1, 2001 through December 31, 2003. The examination was made pursuant to the National Association of Insurance Commissioners' plan of examination. The examination included a review of the Company's practices and procedures, an examination of management records, tests and analyses of detailed transactions within the examination period, and an evaluation of the assets and a determination of liabilities as of December 31, 2003, as deemed necessary under the circumstances.

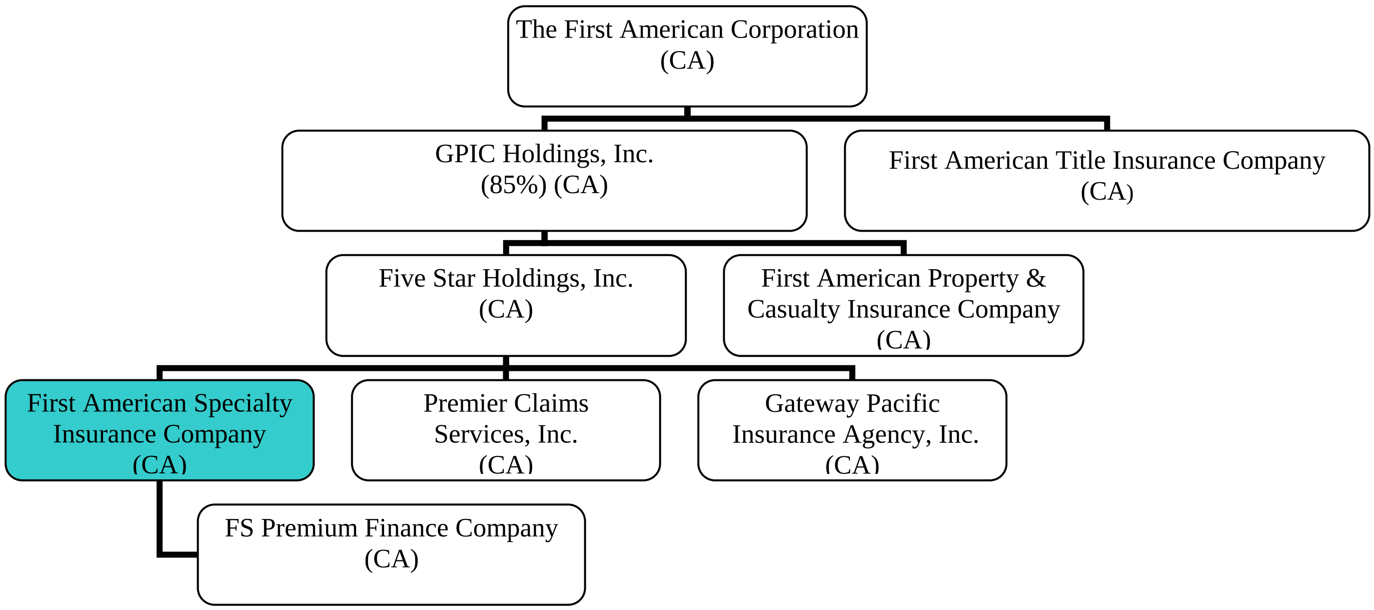
In addition to those items specifically commented upon in this report, other phases of the Company's operations were reviewed including the following areas that require no further comment: corporate records; fidelity bonds and other insurance; officers', employees' and agents' welfare and pension plans; growth of company; business in force by states; loss experience; and sales and advertising.

COMPANY HISTORY

The Company, formerly known as Five Star Insurance Company (Five Star) was incorporated under the laws of the State of California on August 1, 1986, and commenced business on May 18, 1987. On October 19, 2000, Five Star changed its name to First American Specialty Insurance Company subsequent to the acquisition of its parent company, GPIC Holdings, Inc., by First American Corporation in November 1999. During 2002, the Company received a cash contribution of $6,320,000 from its parent company.

MANAGEMENT AND CONTROL

The Company is a wholly-owned subsidiary of Five Star Holdings, Inc. The First American Corporation is the ultimate holding company. The following abridged organizational chart depicts the Company's relationship within the holding company system:



(*) all ownership is 100% unless otherwise noted

Management of the Company is vested in a six-member board of directors elected annually. A listing of the members of the board and principal officers serving on December 31, 2003 follows:

<u>Directors</u>

<u>Name and Residence</u>	<u>Principal Business Affiliation</u>
George M. McNamee Corona Del Mar, California	Chairman of the Board First American Property & Casualty and First American Specialty Insurance Companies
Dirk R. McNamee Corona Del Mar, California	President First American Property & Casualty and First American Specialty Insurance Companies
George J. Grupp Mission Viejo, California	Executive Vice President and Chief Financial Officer First American Property & Casualty and First American Specialty Insurance Companies

Name and Residence	Principal Business Affiliation
Parker S. Kennedy Orange, California	Executive Vice President The First American Corporation
Craig I. Deroy Rolling Hills Estates, California	Senior Executive Vice President and General Counsel The First American Corporation
Kathleen M. Collins Long Beach, California	Vice President, General Counsel and Secretary The First American Corporation

Principal Officers

Name	Title
George M. McNamee	Chairman
Dirk R. McNamee	President
George J. Grupp	Executive Vice President, Chief Financial Officer and Treasurer
Kathleen M. Collins	Vice President, General Counsel and Secretary
Parker S. Kennedy	Executive Vice President
Kelly Dunn	Vice President, Chief Operating Officer

Management Agreements

Management Services Agreement: The Company and its affiliates are parties to a Management Services Agreement. First American Title Insurance Company (FATIC) provides various administrative services for the Company and its affiliates. The Company and its affiliates reimburse FATIC for the actual cost of these services. The agreement has been in-force since January 1, 2002. The agreement was approved by the California Department of Insurance (CDI) on September 3, 2003.

Tax Allocation Agreement: The Company and its affiliates are parties to a tax allocation agreement dated December 15, 1994 with its ultimate parent, First American Financial Corporation (FAF). FAF files consolidated federal income tax returns and pays consolidated federal income taxes due.

The allocation of federal income tax liability is based on the percentage that the separate federal tax liability bears to the sum of the tax liabilities for all members. The members of the group that have incurred losses or other tax benefits that have been utilized by the group to reduce consolidated federal tax liability are compensated for the use of benefits. Any excess of the amount paid over the allocated liability shall be paid back by FAF within ninety days after the due date, including extensions of the consolidated federal return.

Managing General Agency Agreement: The Company entered into an agency agreement with an affiliate Gateway Pacific Insurance Agency, Inc. (Gateway) on January 1, 2001. Under this agreement, Gateway underwrites on behalf of the Company, and is liable for the payment of all premiums, whether collected or not, the net amount due on all business after deducting commissions. The Company pays Gateway a 20% commission on all lines written by Gateway.

Holding Company Transactions

The Company has been providing certain administrative services, primarily consisting of office staff, office space and other services to the affiliated general agent, Gateway. However, the Company does not have an underlying service agreement with Gateway addressing the services provided by the Company to its affiliate. The managerial and administrative services, income taxes allocation and payroll activities are the major components of inter-company transactions and exceeded 3% of the Company's prior year admitted assets. The Company reported in its Form B filing that the expenses reimbursable from Gateway were $6,252,258 in 2003. It is recommended that the Company and Gateway enter into a formal written agreement that addresses services to be provided and settlement provisions for amounts due to/from affiliates. Also, pursuant to California Insurance Code (CIC) Section 1215.5(b)(4), it is recommended that the Company file the proposed agreement for review by the CDI.

The Company receives reimbursement from First American Property & Casualty Insurance Company (FAPCIC) for administrative and other overhead expenses incurred by the Company on behalf of the FAPCIC. The Company reported these cost allocations in its 2003 Form B filing. However, the Company does not have an underlying cost-sharing agreement with FAPCIC to address the allocation method and percentage. It is recommended that the Company enter a cost-sharing agreement with FAPCIC to comply with CIC Section 1215.5(b) (4).

TERRITORY AND PLAN OF OPERATION

As of December 31, 2003, the Company was licensed to transact multiple lines of property and casualty insurance in four states: Arizona, California, Nevada and New York. In 2003, the Company wrote $105.4 million of direct premiums, all in California. The principal line of business written is homeowners multiple peril, which amounted to approximately 80% of the Company's total premiums written. The Company's business is written primarily through its affiliated agency, Gateway Pacific Insurance Agency, Inc.

REINSURANCE

Assumed

The Company has no reinsurance assumed.

Ceded

The following is a summary of the principal ceded reinsurance treaties inforce as of December 31, 2003. Reinsurers with less than 10% participation have been accumulated and listed in aggregate.

Type of Contract	Reinsurer's Name	Company's Retention	Reinsurer's Maximum Limits
Excess of Loss	General Reinsurance Corporation	Property: $500,000 per risk Liability: $500,000 per occurrence	Property: $500,000 xs $500,000, and $1million xs $500,000 per risk Liability: $500,000

			xs $500,000, and $1million xs $500,000 per occurrence
Excess Catastrophe	American Reinsurance Company Continental Casualty Company Converium Reinsurance Inc. Everest Reinsurance Company Platinum Underwriters Reinsurance Inc. Lloyds Syndicates Other Various Reinsurers	$5 million each occurrence	1st Cat: $5 million xs $5 million 2nd Cat: $10 million xs $10 million 3st Cat: $20 million xs $20 million 4st Cat: $20 million xs $40 million
Quota Share	First American Property & Casualty Insurance Company	51%	49%
	General Cologne Reinsurance Corporation	55%	Property: 45% of $500,000 each risk Liability: 45% of $500,000 each occurrence

As of December 31, 2003, reinsurance recoverable, for all ceded reinsurance totaled $114.5 million or 654% of surplus as regards policyholders. Among all ceded reinsurance of $114.5 million, $86.9 million or 497% of surplus were from affiliated authorized reinsurers including $53 million or 303% of surplus from First American Property & Casualty Insurance Company (FAPCIC) as the result of the quota-share arrangement to balance the surplus between the Company and FAPCIC. Among all ceded reinsurance of $114.5 million, $107.1 million or 611% of surplus were from authorized reinsurers and $7.4 million were from unauthorized reinsurers or 43% of surplus as regards policyholders.

In addition, reinsurance recoverable of $46 million, or 270% of surplus, was from various excess catastrophe reinsurers as the result of the Southern California Firestorm that occurred during October of 2003. The Company had reinsurance recoverable in dispute $3.5 million, or 20% of surplus as regards policyholders, as of December 31, 2003.

ACCOUNTS AND RECORDS

During the course of the examination of agents' balances in the course of collection account, it was noted that the Company did not provide the underlying policy level detail in an aged format to support the reported balance. The Company has a managing general agency agreement with its affiliated general agent, Gateway Pacific Insurance Agency, Inc.(Gateway) stipulating that Gateway remits to the Company after the end of each month the net amount due on all business written after deducting its commission, whether collected or not. The NAIC Statement of Statutory Accounting Principles No. 6 states that the aging of the premiums is governed by the effective date of the underlying insurance contract, and not the agent and the Company contractual relationship. It is recommended that the Company provide the policy level aging detail for examinations in the future. It is recommended that the Company establish the proper aging procedures for each of the detailed policy inventory of agents' balances. It is also recommended that the Company maintain a complete audit trail from the Annual Statement to individual detailed records to facilitate the examination.

FINANCIAL STATEMENTS

The financial statements prepared for this examination report include:

Statement of Financial Condition as of December 31, 2003

Underwriting and Investment Exhibit for the Year Ended December 31, 2003

Reconciliation of Surplus as Regards Policyholders
from December 31, 2000 through December 31, 2003

Reconciliation of Examination Changes as of December 31, 2003

Statement of Financial Condition
as of December 31, 2003

Assets	Assets	Assets Not Admitted	Net Admitted Assets	Notes
Bonds	$ 33,697,791	$	$ 33,697,791	
Stocks:				
Preferred stocks	548,611		548,611	
Common stocks	9,828,722		9,828,722	
Cash and short-term investments	19,587,038		19,587,038	
Agents' balances or uncollected premiums:				
Premiums and agents' balances in course of collection	2,210,437		2,210,437	
Reinsurance recoverable on loss payments	28,271,299		28,271,299	(1)
Net deferred tax asset	2,382,476		2,382,476	(4)
Electronic data processing equipment	844,120	442,088	402,032	
Interest and dividends income due and accrued	648,139		648,139	
Receivable from parent, subsidiaries and affiliates	2,062,784		2,062,784	
Other assets nonadmitted	62,889	62,889	0	
Aggregate write-ins for other than invested assets	1,391,105	1,391,105	0	(2)
Total assets	$ 101,535,411	$ 1,896,082	$ 99,639,329	

Liabilities, Surplus and Other Funds			
Losses		$ 9,757,041	(3)
Loss adjustment expenses		2,410,804	(3)
Other expenses		2,305,112	
Taxes, licenses and fees		950,488	
Federal and foreign income taxes		428,274	
Unearned premiums		13,914,036	
Ceded reinsurance premiums payable		42,900,417	(1)
Amounts withheld by company for account of others		180,984	
Provision for reinsurance		915,582	
Drafts outstanding		8,406,004	
Payable to parent, subsidiaries and affiliates		1,045,312	
Total liabilities		83,214,054	
Common capital stock	$ 2,000,000		
Gross paid-in and contributed surplus	8,670,000		
Unassigned funds (surplus)	5,755,275		
Surplus as regards policyholders		16,425,275	
Total liabilities, surplus and other funds		$ 99,639,329	

Underwriting and Investment Exhibit
for the Year Ended December 31, 2003

Statement of Income

Underwriting Income		
Premiums earned		$ 39,561,340
Deductions:		
Losses incurred	$ 23,051,876	
Loss expense incurred	2,942,586	
Other underwriting expenses incurred	8,865,527	
Total underwriting deductions		34,859,989
Net underwriting gain		4,701,351
Investment Income		
Net investment income earned	$ 1,992,747	
Net realized capital gains	(41,690)	
Net investment gain		1,951,057
Other Income		
Finance and services charges not included in premiums	$ 235	
Total other income		235
Net loss before federal income taxes		6,652,643
Federal income taxes incurred		1,831,310
Net income		$ 4,821,333

Capital and Surplus Account

Surplus as regards policyholders, December 31, 2002		$ 13,157,910
Net income	$ 4,821,333	
Net unrealized capital gains	1,203,510	
Change in nonadmitted assets	(1,716,694)	
Change in provision for reinsurance	(915,582)	
Aggregate write-ins for losses in surplus	(125,202)	
Change in surplus as regards policyholders		3,267,363
Surplus as regards policyholders, December 31, 2003		$ 16,425,275

Reconciliation of Surplus as Regards Policyholders
from December 31, 2000 through December 31, 2003

	Gain in Surplus	Loss in Surplus	
Surplus as regards policyholders, December 31, 2000, per examination			$ 8,522,705
Net income	$ 3,704,599	$	
Net unrealized capital gains	519,056		
Change in net deferred income tax		221,347	
Change in nonadmitted assets		875,931	
Change in provision for reinsurance		915,582	
Cumulative effect of changes in accounting principles	77,444		
Surplus adjustments: Paid-in	6,320,000		
Aggregate write-ins for losses in surplus		705,669	
Totals	$ 10,621,099	$ 2,718,529	
Net increase in surplus as regards policyholders			7,902,570
Surplus as regards policyholders, December 31, 2003, per examination			$ 16,425,275

Reconciliation of Examination Changes
as of December 31, 2003

Assets	Per Company	Per Examination	Surplus Increase (Decrease)	Notes
Reinsurance recoverable from reinsurers	$ 5,770,132	$ 28,271,299	$ 22,501,167	(1)
Aggregate write-ins for other than invested assets	1,087,570	0	(1,087,570)	(2)
Liabilities				
Ceded reinsurance premiums payable	20,399,250	42,900,417	(22,501,167)	(1)
Net decrease to surplus as regards policyholders			(1,087,570)	
Surplus as regards policyholders, December 31, 2003 per Company			17,512,845	
Surplus as regards policyholders, December 31, 2003 per Examination			$16,425,275	

COMMENTS ON FINANCIAL STATEMENT ITEMS

(1) Reinsurance Recoverable from Reinsurers

(1) Ceded Reinsurance Premiums Payable

The Company offset reinsurance recoverable from its affiliated reinsurer First American Property & Casualty Insurance Company (FAPCIC) with ceded premium payable to FAPCIC in the amount of $22.5 million at year-end of 2003. The NAIC Statements of Statutory Accounting Principles (SSAP) No.62 prescribes that reinsurance recoverable on paid losses shall be reported as an asset without any available offset. Thus reinsurance recoverable from reinsurers at $22.5 million was reclassified from ceded reinsurance premiums payable. It is recommended that the Company comply with SSAP No.62 to record reinsurance recoverable on paid losses separately without any offsetting and properly report it in the account and Schedule F of its Annual Statements.

(2) Aggregate Write-Ins for Other Than Invested Assets

The Company reported $1,087,570 for the above captioned account, which reflected the contingent commissions accrued for reimbursement from the reinsurer, General Reinsurance Corporation, based on the quota-share reinsurance treaty effective December 1, 2003, and included all policies in force. According to the treaty, the contingent commissions are based upon the profitability of the business produced, and the reinsurer shall render to the Company a statement of contingent commission for the term of the agreement and annually thereafter. At year-end 2003, the treaty had been effective for only one month and the reinsurer did not provide a statement of contingent commissions; therefore, recognizing the company has indicated an offsetting adjustment, an examination adjustment was made to nonadmit the contingent commissions $1,087,570 as the potential offset could impact the Company's reserves for losses and loss adjustment expenses which have been deemed reasonable as reported. It is recommended that the Company record its contingent commissions at the end of the term of the agreement and annually thereafter in accordance with the treaty provision. The Company agreed to make the appropriate adjustments to the contingent commissions in its subsequent statutory statements.

(3) Losses and Loss Adjustment Expenses

The Company's reserves for losses and loss adjustment expenses were prepared by the Company's consulting actuary. Based on the review by a Casualty Actuary from the California Department of Insurance, the Company's reserves for losses and loss adjustment expenses at year end 2003 were determined to be reasonable and have been accepted for purposes of this examination.

(4) Federal Income Taxes Provision

The Company recorded federal income taxes incurred at $1.8 million in its 2003 Annual Statement. The Company calculated the federal income taxes incurred based on the statutory income, and did not incorporate any book and tax differences to adjust its statutory income to taxable income. As a result, the above captioned account was understated by $3 million at year-end 2003. Meanwhile, the Company did not record the change in net deferred income tax as an increase to surplus. Due to the neutral impact on the Company's surplus, no examination adjustments were made.

In addition, the examination of deferred taxes disclosed the deficiencies in calculating net deferred taxes such as the undocumented determination of tax basis of the components of deferred items and the reversal pattern and timing of the temporary difference associated with loss reserves. It is recommended that the Company improve its recording and reporting of deferred taxes to comply with the NAIC SSAP No. 10.

SUMMARY OF COMMENTS AND RECOMMENDATIONS

Current Report of Examination

Management and Controls – Holding Company Transactions (Page 5): It is recommended that the Company obtain the prior approval from the California Department of Insurance and enter into a management administrative service agreement with its affiliate Gateway Pacific Insurance Agency, Inc. to comply with California Insurance Code (CIC) Section 1215.5(b) (4). It is recommended that the Company enter into a cost-sharing agreement with its affiliate, First American Property & Casualty Insurance Company. It is recommended that the Company implement its tax allocation agreement properly.

Accounts and Records (Page 8): It is recommended that the Company provide the policy level aging details for the examination in the future. It is recommended that the Company establish the proper aging procedures for each of the detailed policy inventory of agents' balances. It is also recommended that the Company maintain a complete audit trail from the Annual Statement to individual detailed records to facilitate the examination.

Comments on Financial Statement Items – Reinsurance Recoverable from Reinsurers; Ceded Premiums Payable (Page 13): It is recommended that the Company comply with the NAIC Statement of Statutory Accounting Principles (SSAP) No.62 to record reinsurance recoverable from reinsurers separately without any offsetting and properly report it in the account and Schedule F of its Annual Statements.

Comments on Financial Statement Items – Aggregate Write-ins for Other Than Invested Assets (Page 13): It is recommended that the Company record its contingent commissions in accordance with the reinsurance treaty provision.

Comments on Financial Statement Items – Federal Income Taxes Provision and Deferred Taxes (Page 14): It is recommended that the Company adjust its statutory income to taxable income to calculate its federal income tax provisions. It is recommended that the Company improve its reporting of deferred taxes to comply with the NAIC SSAP No. 10.

Previous Report of Examination

Management and Control – Affiliated Company Agreements (Page 5): It was recommended that the agreements be amended to reflect the new name of the Company. The agreements were amended reflecting the new name of the Company.

Corporate Records (Page 6): It was recommended that the Company implement procedures to ensure future compliance with CIC Section 735. The Company complied with CIC Section 735.

Reinsurance – Ceded (Page 7): It was recommended that the Company amend its reinsurance agreement to meet the requirements of CIC Section 922.2(a)(2). The Company amended its reinsurance agreement to meet the requirements of CIC Section 922.2(a)(2).

Accounts and Records – (Page 8): It was recommended that the Company evaluate the recommendations and make appropriate changes to strengthen its information system controls. The Company made the appropriate changes to strengthen the addressed information system controls.

Comments on Financial Statements – Bonds (Page 13): The NAIC Accounting Practices and Procedures Manual requires that bonds and stocks be valued at market as determined by the NAIC's Securities Valuation Office (SVO). It was recommended that the Company use market values published by the SVO. The Company implemented this recommendation.

Comments on Financial Statements – Cash and Short-term Investments (Page 13): It was recommended that the Company change the name on the bank accounts to reflect the Company's new name. In addition, it was recommended that the Company record bank reconciliation adjustments in a timely manner and to reflect the "reconciled" book balance in the Annual Statement. The Company implemented these recommendations.

Comments on Financial Statements – Reinsurance Recoverable on Loss Payments (Page 14): It was recommended that the Company submit proper documentation to the reinsurer or intermediary in a timely manner for all reinsurance recoverable. The Company implemented this recommendation.

Comments on Financial Statements – Drafts Outstanding (Page 14): It was recommended that the Company make the necessary Unclaimed Property Act Filing annually with the states in which it conducts business. The Company implemented this recommendation.

ACKNOWLEDGEMENT

The courtesy and cooperation extended by the Company's officers and employees during the course of this examination are hereby acknowledged.

Respectfully submitted,

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Irene Song, CFE
Associate Insurance Examiner
Examiner-In-Charge
Department of Insurance
State of California